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High Growth in China – Transition without a Transition Crisis?

Unlike other transition economies the People's Republic of China has so far not only avoided a severe transition crisis; it has apparently also managed to make economic transition a source of growth. However, the country now faces a number of crucial transition problems that centre around the debt situation of state-owned enterprises and the fragile condition of the financial system. Could these problems, for which solutions have repeatedly been postponed, trigger a late transition crisis?

Since economic reforms began to be introduced in 1978, the People's Republic of China has experienced more than two decades of rapid growth. This performance has some similarities with the catching-up process experienced by Japan after World War II, and the 'Asian Miracle' exhibited by the 'tiger' economies. Like the other Asian countries, China has a mixed economy with a strong interventionist state, and is quite unlike the modern Western ideal of a pure market economy. But, due to its communist legacy, China is also a transition economy. And, unlike any other transition economy, it has succeeded not only in avoiding a severe transition crisis; it has also apparently managed to make transition a source of growth.

There are several competing approaches to explaining China's rapid growth. Some argue it is only a statistical artefact resulting from a politically biased statistical base, and a systematic underestimation of inflation. Others claim it is due merely to a shift from household production to market-oriented production which is included in GDP. Some analysts point to the unprecedented exploitation of natural resources, while others underline the important influence of foreign direct investment (FDI). Most analysts would probably stress the analogy with the other countries associated with the Asian Miracle,[1] even if these have lost some of their attraction since they were hit by financial crisis. In fact, there is probably some truth in all these propositions, but in our opinion they do not touch on the key to the poorly understood phenomenon of economic growth in China, and in the first part of this article we offer our own explanation of this issue.

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As China begins to be faced with stuttering growth, emerging deflation and the danger of being infected with a late dose of the Asian crisis, the question arises of whether it really will be able to avoid a transition crisis. Many of the crucial transition problems faced in China centre around the overindebted situation of state-owned enterprises (SOEs) and the fragile condition of the financial system. Could these problems, for which solutions have repeatedly been postponed, trigger a late transition crisis? Leaving aside other possible sources of a financial crisis, such as a sharp devaluation of the Renminbi or exogenous shocks from Asia,[2] we conclude that there is no necessity for a transition crisis to occur provided the appropriate policies are pursued. However, even in the event that transition is successful, high growth may fade somewhat and this will exacerbate unemployment. We discuss these issues in the second part of the article.

In 1998 the Chinese government adopted an expansive fiscal policy in order to combat deflationary tendencies in the economy, and in the last part we discuss the appropriateness of these measures, which were designed to avoid following in the steps of Japan's recent recession.

Sources of High Growth in the Chinese Economy

Since the start of the reform process in 1978-79, China has registered impressive rates of economic

[1] World Bank: The East Asian Miracle. Economic Growth and Public Policy, Washington, D.C. 1993.

[2] N. Schlotthauer: Will the People's Republic of China Trigger Off the Next Asian Crisis? in: INTERECONOMICS, Vol. 34 (1999), No. 3, pp. 124-135; P. Rieger: China im Sog der Asienkrise, in: Wirtschaft und Gesellschaft, Vol. 4 (1998), pp. 559-565; F. J. Gurtner: The Stability of the Renminbi in the Wake of the Asian Financial Crisis, in: INTERECONOMICS, Vol. 34 (1999), No. 3, pp. 135-143.

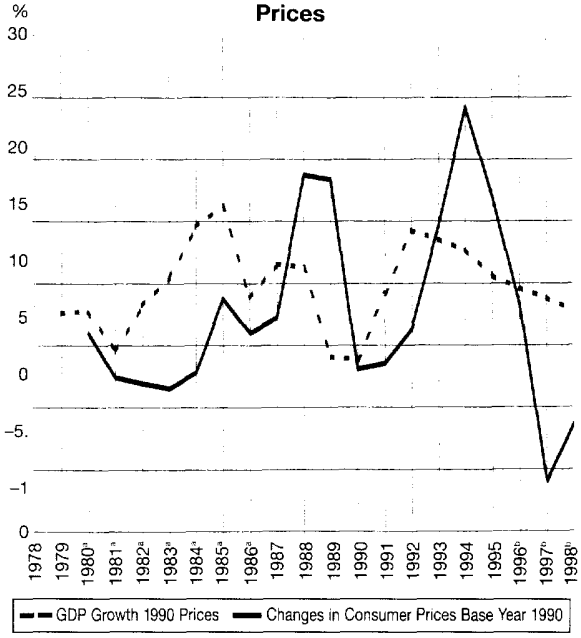
growth (cf. Figure 1).[3] The growth process was cyclical with strong upswings being especially apparent during the mid-eighties and from 1992 to 1994. During the first years of reform GDP growth was driven by the agricultural sector, but subsequently the rate of growth in manufacturing industry and the service sector was much higher.[4] In 1979 agricultural production contributed over 30 per cent of GDP, while nowadays its share is about 18 per cent.[5]

Inflation has also been cyclical. It gained momentum in the years 1988-89 and 1993-94, in each period reaching rates of about 20 per cent (cf. Figure 1), although the government managed to reduce inflation to low rates following each of the two spurts. However, the success against inflation was only achieved at the price of slower growth. In 1989 and 1990, growth rates dropped to 4.1 per cent and 3.8 per cent respectively. After 1993-94, the landing was softer, but growth did not recover as strongly as it had previously; rather, it showed a falling trend. In 1995-96 inflation rates dropped radically and China is now on the edge of a potentially long-lasting deflation.

Slower growth and deflation indicate that China is facing a critical economic situation. Compared with other transition countries, the performance of China in respect of growth and monetary stability has been extremely successful. All transition countries in Central and Eastern Europe had to accept deep and, in some cases, long-lasting recessions, often in combination with an erosion of their monetary systems.[6] Why was China so successful in respect of growth and improvements in the living standard of its people? The answer is important not only for understanding past developments; it also provides clues as to whether the driving forces for growth can be preserved.

Our main thesis is that growth in China has, in the first place, been driven by high investment demand. Taking 1990 as 100, real GDP increased from 38.9 in 1979 to 158.4 in 1994. During the same period real gross domestic fixed investment increased even faster, from 43.4 to 213.7 (cf. Table 1). In addition to the high growth of investment demand, investment is also very high in relation to GDP. Gross fixed capital formation as a per cent of GDP (the investment ratio) reached a figure of more than 30 per cent in some

Figure 1
GDP Growth Rate and Changes in Consumer Prices



[a] Overall retail price: The World Bank: The Chinese Economy, Fighting Inflation, Deepening Reforms, Washington D.C. 1996.
[b] The People's Bank of China Quarterly Statistical Bulletin 1999-1.

Source: IMF: International Financial Statistics 1997.

Table 1
National Account Indicators
(1990 = 100 in constant 1990 prices)

	1979	1994	Average growth rate 1979-94
Gross domestic product	38.9	158.4	9.8
Gross domestic fixed investment	43.4	213.7	11.2
Non-government consumption	38.8	150.0	9.4
General government consumption	48.9	174.3	8.8
Exports of goods & non-factor services	8.0	187.1	16.9
Imports of goods & non-factor services	27.3	211.3	15.0

Source: World Bank: The Chinese Economy. Fighting Inflation, Deepening Reforms, Washington, D.C. 1996.

[3] According to Chinese government figures, the average annual growth rate between 1978 and 1996 was 9.9 per cent. However, the deflator employed may have overstated real growth. The World Bank, for example, estimated that the annual growth rate between 1978 and 1996 was 7.9 per cent (World Bank: China 2020: Development Challenges in the New Century, Washington, D.C. 1997, p. 3).

[4] Between 1984 and 1993 the annual growth of real GDP in agriculture was 4.7 per cent, in industry it was 13.3 per cent, in manufacturing 12.7 per cent and in services 1.2 per cent (World Bank: The Chinese Economy. Fighting Inflation, Deepening Reforms, Washington, D.C. 1996, p. 5).

[5] World Bank: The Chinese Economy..., op. cit.; Bundesstelle für Außenhandelsinfomation: Wirtschaftsdaten Aktuell, VR China, 23 June, 1999.

[6] H. Herr, S. Tober: Unterschiedliche Marktkonstellationen. Was unterscheidet die Entwicklung in der VR China von den Ländern der ehemaligen Sowjetunion und den Visegradstaaten?, in: H. Herr, K. Hübner (eds.): Der lange Marsch in die Marktwirtschaft, Berlin 1999, pp. 77-118.

years (cf. Table 2). Among large economies, China has the highest investment ratio in the world, and among small countries only Hongkong and Singapore have similar or higher ratios. As a result, the shares of private consumption and government expenditure in GDP are relatively low. Public revenues and expenditures as a share of GDP have declined considerably (cf. Figure 2). This reflects a long-term trend for the government's role in the economy. By international standards, the role of public sector expenditure is relatively unimportant in China. The high growth rate of investment together with the high proportion of investment in GDP explains why investment demand must have been the backbone of Chinese economic development since 1978.

High Internal Investment

Several factors are important in understanding the impressive investment performance in China. First of all, China implemented what it calls a 'dual-track system', which involves the coexistence of two ownership systems with different regulations. The first system consists of state-owned enterprises (SOEs). Until the mid-1980s, most SOEs were still assigned, at least partly, to a compulsory planning system. Even more important is the fact that until now there has been a credit plan (see below). One of the aims of the credit plan has been to finance investment planned by the state. These so-called policy loans became substitutes for direct quantitative planning, the importance of which has been slowly reduced. According to estimates by the World Bank,[7] a third of total investment in 1994 was financed by direct policy loans. For policy loans the central bank usually provides special credits to the four dominant state-owned commercial banks.[8] Consequently, these banks re-lend funds from the central bank to priority sectors selected by the central government. In addition, until recently local governments strongly influenced the allocation of credit by the four big state-owned banks at a local level. Data about this type of policy loan is very difficult to obtain. Lardy[9] calculates that in 1991 more than 40 per cent of all credits granted by the four state-owned commercial banks can be considered as policy loans. This is very large, given that in 1998, the four state-owned banks still held 76 per cent of all reported credits in the Chinese financial system.[10]

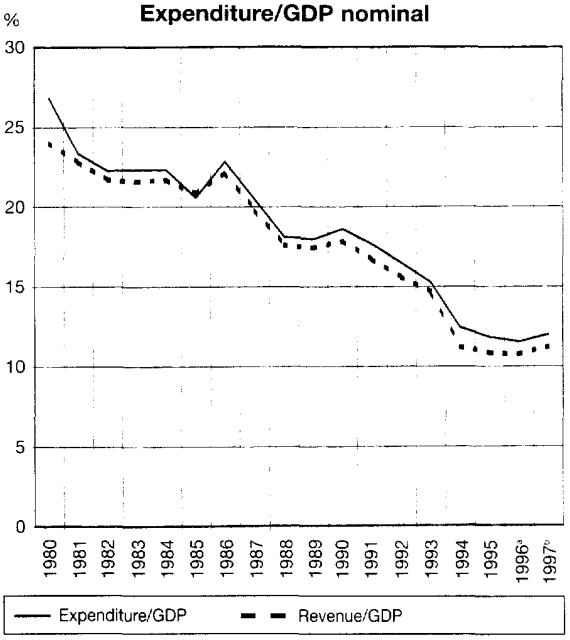
The existence of policy loans means that both the structure and aggregate quantity of a large proportion of investment has been regulated by the state. This explains, at least partly, why the level of investment has been so high, and in particular, why investment

Table 2
Proportion of Investment and Consumption to GDP
(in per cent)

	Gross fixed capital formation	Private consumption	General government consumption
1980	29.2	51.3	14.5
1985	29.5	51.1	13.2
1990	25.5	49.1	12.1
1995	34.6	45.6	11.8

Source: IMF: International Financial Statistics, Washington, D.C. 1997.

Figure 2
Government Revenue and Expenditure/GDP nominal



[a] The People's Bank of China Quarterly Statistical Bulletin 1999.
[b] Forecasted by economic staff.

Source: IMF: International Financial Statistics 1997.

[7] World Bank: The Chinese Economy..., op. cit., p. 28.

[8] These banks (Agricultural Bank of China, Bank of China, Construction Bank, Industrial and Commercial Bank of China) were created during the reform of the monobank that existed under the planned economy prior to 1978. In addition, in 1994 three special policy banks (Agricultural Development Bank, Export-Import Bank of China, Agricultural Development Bank) were founded. The aim is to clean up all the policy loans from the balance sheets of the state-owned commercial banks and concentrate them on the special policy banks.

[9] N. R. Lardy: China's Unfinished Economic Revolution, Washington, D.C. 1998, p. 86.

[10] People's Bank of China: Quarterly Statistical Bulletin, Vol. XIII (1999), No. 1.

State Enterprise Reforms

1978-87: general principles of economic reforms formulated by central bank; law on joint ventures; start of price liberalisation in agriculture; fiscal autonomy for local government; creation of special economic zones; introduction of private income tax; liberalisation of consumer prices begins; SOE reform 'tax for profits'; bank lending begins to replace budget allocations to state enterprises; collectively owned enterprises promoted; transformation of the People's Bank of China into a central bank; 14 coastal cities open up; township and village enterprises created

1988: state enterprise contract responsibility begins; regulations on private enterprise system published; enterprise law and bankruptcy law passed

1989: regulations on mergers, joint stock companies, commercialisation of banks

1991: pension and housing reforms start; promotion of corporatisation

1992: directives on new operating mechanism and 14 autonomous rights for SOEs issued; phasing out of production targets and price controls (with some exceptions); progress on trade liberalisation

1993: decision of Third Plenum on 'modern enterprise system' by 2000

1994: reforms of the foreign-exchange and tax systems; lowering budgetary subsidies to SOEs; launching the 10,000-1,000-100-10 programme; design of industrial policy framework and creation of 56 enterprise groups in 'pillar' industries; enactment of company law

1995: encouragement of mergers of non-state firms with SOEs; regulations to clarify ownership rights of the state

1996: concentration of state control on the group of 1,000 large SOEs and reduction of control on 90,000 small enterprises

1997: announcement of radical SOE reforms at the XVth Party Conference: commercialisation and corporatisation; mergers; sales and auctions of small SOEs

1998: regrouping of 'pillar' industries; the respective branch ministries transformed into offices of the 'Commission for Economy and Commerce'; companies in petroleum, gas and chemical industries merged and regrouped in a northern and southern China company; similar plans announced for other heavy industries such as steel and non-ferrous metals

Sources: World Bank: The Chinese Economy. Fighting Inflation, Deepening Reforms, Washington, D.C. 1996 ; H. Feldmann, S. Opper: Die neuen Reformen der chinesischen Staatsbetriebe, in: Osteuropa-Wirtschaft, Vol. 43 (1998), No. 4, pp. 396-414; Länderanalysen der Frankfurter Allgemeinen Zeitung und des Ostasiatischen Vereins e.V., VR China/Hongkong, Frankfurt am Main, November 1998.

has recovered so rapidly following periods of restrictive economic policy.[11] To understand the present situation of the Chinese economy it is important to note that quantitative planning of the economy no longer exists, and that policy loans have been substantially reduced in recent years.

Apart from the issue of policy loans, SOEs in China had a form of 'investment hunger' that is a well known feature of enterprises in planned economies. In planned economies, enterprises desire to invest as much as possible, quite independently of the profit situation, which does not play an important role. One reason for this is that the success of managers was measured by the growth of their enterprises and the well-being of the workers. At all events, this type of investment behaviour has survived in SOEs, even since the abolishment of quantitative planning. This means that in China much investment behaviour has not been orientated to future profitability, and, until recently, a lack of investment was never a problem. Of course not all of this investment was used efficiently. But this lack of efficiency has to be assessed in the light of the high growth of GDP, which seems to have compensated for distortions in resource allocation. One of the problems which China now faces is that, within the dual-track system, SOEs have declined in importance, and investment decisions now follow a more market-oriented logic. This is positive as far as resource allocation is concerned, but it can hurt growth. Improved resource allocation does not automatically lead to higher growth. Rather, if aggregate demand is too low, it can lead to an under-utilisation of resources and, in particular, to unemployment.

One aim of the dual-track system was to slowly 'grow out of the plan'.[12] New enterprises were to be founded in market niches not filled by SOEs. SOEs were also to be confronted with competition from new enterprises in their traditional, more or less monopolised, fields. According to the idea of the so-called socialist market economy, a strong state-owned enterprise sector should exist – and not only on a transitory basis – at least in key industries. But these enterprises, so the idea, should act within a market environment and become highly efficient. This aim was only partially achieved. During the 1980s a huge number of new collectively owned enterprises were created.[13] In the new, market track of the dual system,

[11] In developed market economies there is always the danger that investment demand remains sluggish even if interest rates have been reduced after a period of restrictive monetary policy.

[12] B. Naughton: Reforming a Planned Economy: Is China Unique?, in: C. H. Lee, H. Reisen (eds.): From Reform to Growth, China and other Countries in Transition in Asia and Central and Eastern Europe, OECD, Paris 1994, pp. 49-73.

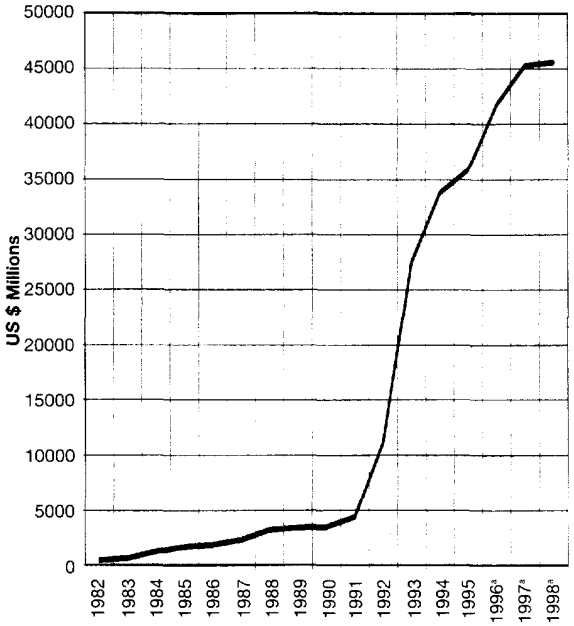
these enterprises were one of the most dynamic forces, as the SOEs, which reformed themselves only slowly, provided many opportunities to expand. Collectively owned enterprises also had a high investment demand as there were opportunities for high profits.

In the 1990s, the creation of new enterprises intensified, with the establishment of numerous joint ventures and private enterprises, which previously had not been legally permitted. Step-by-step, non-SOEs became successful competitors in the markets for goods and services that had traditionally been dominated by SOEs. The big advantage of the collectively owned enterprises (and the private enterprises) is that, unlike SOEs, they do not have to finance the social safety net. They do not have to care for housing, for pensions and even for hospitals and schools, and they can sack workers. By 1998 SOEs contributed less than 14 per cent of GDP, and less than 28.5 per cent of industrial output (see boxes). The aim of reducing the role of SOEs in the economy was therefore achieved. But it did not prove possible to transform the SOE sector into a modern enterprise sector that could become an engine of economic development. Rather, the SOE sector has become the biggest issue for Chinese policy-makers during recent years.

Foreign Direct Investment

The stock of FDI in China was estimated to be US$ 266 billion in 1998.[14] Until 1991 FDI flows were rather small and never exceeded US$ 4.5 billion. In 1992 FDI inflows started to increase and reached levels of over US$ 45 billion per annum between 1996 and 1998 (cf. Figure 3). In 1996, worldwide FDI flows were US$ 315 billion, and China was the second largest recipient after the USA. China attracts far higher FDI inflows

Figure 3
Foreign Direct Investment



[a] The People's Bank of China Quarterly Statistical Bulletin 1999.
Source: IMF: International Financial Statistics 1997.

than the CIS and Eastern European countries, although, calculated on a per capita basis, China's FDI inflows are rather mediocre.[15]

At the end of 1994 there were some 206,000 joint ventures and wholly foreign-owned enterprises in China, and they employed some 18 million people, equal to 2.5 per cent of total employment.[16] The booming FDI inflows in the 90s were the result of a much more liberal approach towards allowing foreigners to enter Chinese markets, and the possibility of establishing wholly foreign-owned firms. The bulk of FDI is concentrated in industry.

In 1996 48.8 per cent of FDI came from Hongkong, 3.1 per cent from Macao and 8.2 per cent from Taiwan, whereas the USA accounted for only 8.2 per cent. About 80 per cent of FDI has come from Chinese firms based in other Asian countries.[17] It is possible that a significant part of FDI inflows to China stem from domestic sources which first flow to Hongkong or other places before flowing back. These may include illegal outflows attracted by a variety of preferential incentives for FDI. The high level of FDI may therefore be partly a statistical artefact.

During the 1980s, FDI was equal to less than 2 per cent of GDP and to about 6 per cent of gross domestic investment. Even more important is that until the early nineties virtually all of the industrial

[13] Collectively owned enterprises are normally owned by local governments and run by worker collectives. They mainly comprise the township and village enterprises, small firms with hard budget constraints, high competitiveness, low capital requirement and labour intensive production techniques. In the mid 90s in this type of nearly privatised ownership already a third of industrial output was produced. See World Bank: From Plan to Market. World Development Report 1996, Washington, D.C. 1996, p. 51, and B. Krug: Privatization in China? Something to Learn From?, in: H. Giersch (ed.): Privatization at the End of the Century, Berlin-Heidelberg 1997, pp. 269-293.

[14] Frankfurter Allgemeine Zeitung, 30.09.99.

[15] J. Priewe: Direktinvestitionen im Transformationsprozess der GUS-Länder, in: Wirtschaft und Gesellschaft, Vol. 2, 1997, p. 233-255, here p. 238.

[16] B. Reddies: Jahresbericht 1998: Gesellschaftliches Kooperationsprogramm VR China, Friedrich Ebert Stiftung, Beijing 1998.

[17] N. Schlotthauer, op. cit., p. 126.

Key Data on State-owned Enterprises in the PR China

Number of SOEs
305,000 total, 114,000 industrial SOEs, 80,000 industrial SOEs with 'independent accounting systems', of which

- 4,000 are classified as 'large SOEs' (accounting for 43% of total SOE employment),
- 10,500 are 'medium-sized SOEs' (accounting for 26% of total SOE employment),
- 65,000 are 'small SOEs' (accounting for 31% of total SOE employment).

Employment
Total employment in all SOEs 109 million (1996), 16% of total labour force; 66 million employees (including contract labourers) in SOE industry (manufacturing), equal to about 2/3 of total employment in manufacturing (1994) or 11% of total labour force; without contract labourers industrial SOE employment amounts to 43 million.

Overemployment in SOEs
Estimation 20% or some 15-20 million persons.

Production
Industrial SOEs estimated to contribute 14% of GDP (1994).
SOEs' contribution to total industrial output shrank from 62.2% in 1986 to 28.5% in 1996.

Investments
SOEs account for 55.7% of total fixed investment and 70% of total industrial investments (1995).

Profits and losses
Profits of industrial SOEs amount to 2% of GDP (1995), current deficits to 7.0%. 44% of industrial SOEs are loss-makers (1995) with an increasing trend. Main loss-makers are small and medium enterprises. During recent years losses exceeded profits, so the net overall performance of SOEs was negative. Loss-making SOEs account for 20.8% of industrial-SOE output, 18% of sales revenues and 41% of employees; main loss-making branches are coal-mining, defence industries, petroleum, non-ferrous metals, and tobacco. In the first quarter of 1999 the overall balance of industrial SOEs reported small net profits. In the first quarter of 1999, 18 of the 30 provinces, autonomous regions and municipalities experienced overall SOE-profits, 12 losses (with a declining tendency).

In 1994 SOEs received subsidies from the state budget and from the financial sector equal to 3.9% of GDP. The peak was 10.2% in 1987.

Indebtedness
SOEs absorb approximately 75% of bank credits; roughly 20% of the banks' credit stock is judged non-performing. These bad debts amount to about 20% of GDP. The net capital value of the four state commercial banks – with a credit market share of round about 80% – is assumed to be negative.

Sources: World Bank: The Chinese Economy. Fighting Inflation, Deepening Reforms, Washington, D.C. 1996; World Bank: China's Management of Enterprise Assets: The State as Shareholder, Washington, D.C. 1997; L. L. Lim et al.: Economic Performance, labour surplus and enterprise responses. Results from the China Enterprise Survey, International Labour Office, Geneva 1996; Y. Cao et al.: From Federalism, Chinese Style, to Privatization, Chinese Style. Stanford University, mimeo, 1997; J. Hebel: Chinesische Staatsbetriebe zwischen Plan und Markt. Von der 'Danwei' zum Wirtschaftsunternehmen, Hamburg 1997; China News Services 5/27/99; Peoples Bank of China: Quarterly Statistical Bulletin, Vol. XIII (1999), No. 1.

output of foreign-invested enterprises was exported. Foreign-invested enterprises were not much more than workbenches for foreign firms that exploited cheap Chinese labour. Such enterprises did not have many connections with the rest of the Chinese economy. The business of foreign-invested firms was to import materials and components and process them for export. In 1995 this so called 'export processing' accounted for half of all China's exports and 90 per cent of exports by foreign-invested firms.[18] Most foreign investment was concentrated in the province of Guangdong,[19] near Hongkong, and in the province Fujian, opposite Taiwan, and was carried out by overseas Chinese. But during the eighties, FDI had little impact on the Chinese economy as a whole.

The situation changed in the early nineties as FDI started to soar. By 1997, FDI was equal to 5.1 per cent of GDP, and accounted for 14.4 per cent of gross fixed investment, which is high by international standards. The share of FDI in fixed investment in Hungary was 34 per cent in 1993, but in most OECD and developing countries the figure is below 10 per cent.[20] Nevertheless, the very high and sustained investment ratio in China is not due mainly to FDI (cf. Table 2). China has not experienced a lack of domestic saving and a need to turn to foreign saving in order to finance investment. Neither China nor other developing countries, in principle, suffer from a lack of financial or real resources. For example, most developing countries experience high unemployment and a capital outflow. This means that investment is not constrained by low household savings. In China the propensity to save is especially high, and growth has mainly been driven by internal investment demand. High invest-

[18] B. Naughton: China's Emergence and Prospects as a Trading Nation, in: Brookings Papers on Economic Activity, No. 2, 1996, pp. 273-337, here pp. 298 ff.

[19] Until the 1990s over one third of foreign direct investment was concentrated in Guangdong (cf. B. Naughton: China's Emergence and Prospects as a Trading Nation, op. cit., p. 278).

[20] J. Priewe, op. cit., p. 239. It has to be taken into account that a large proportion of FDI in reality comes from China itself.

ment spurred high income creation, and high income led to high savings by households.

It is very common to explain high Chinese growth by high Chinese savings.[21] We think that capital accumulation is driven by high investment demand. Given the propensity to save, income creation driven by investment will create sufficient savings to balance net investment and savings. High savings by households can prevent inflation in periods of high investment and excess capacity utilisation. But high savings by households can also reduce growth in a situation of low capacity utilisation. In China this has been the case during recent years. At present, China suffers from a lack of demand that is partly due to high household savings.

In spite of the above argument we do not think that high FDI since the early nineties has had no effect on China. The main impact of FDI on Chinese economic development does not concern the high quantitative level of investment but rather several structural factors.

Firstly, FDI has contributed to technological change and the promotion of productivity increases, mainly in industry. Between 1980 and 1997, GDP per employed person increased by 8.9 per cent per annum (our calculation based on World Development Report 1998/99). Channelling FDI inflows into advanced technological (and export or import-substitution oriented) production by government incentives and controls apparently was effective.[22] Nevertheless, there is no clear empirical evidence showing the magnitude of successful technology transfer as a result of FDI. Furthermore, technology transfer is not only possible by means of FDI. For example, after World War II Japan was very successful as regards technological development without any FDI. It relied mainly on imitating foreign technology, although in some cases it also purchased patents.

Secondly, FDI gave rise to booming foreign trade. In 1996, FDI enterprises accounted for 47.3 per cent of total foreign trade (40.7 per cent of exports and 54.5 per cent of imports). Despite the government's attempt to ensure that foreign-invested firms maintain a balance in their foreign-exchange transactions, their imports exceeded their exports by 23 per cent in 1996.[23] This is in line with the general tendency towards increasing imports induced by foreign-invested enterprises in most developing (and other) countries. Although most foreign investors come to China in order to take advantage of the prospective growth of the domestic market, Chinese policy has strongly encouraged them to expand exports. As a result, despite the huge inflow of FDI, China has succeeded in avoiding a current account deficit. China's export quota (exports/GDP) has reached 20 per cent, which is rather high for a large economy and makes the country vulnerable to external shocks. The high export quota therefore reveals a contradictory feature of the Chinese economy: it is a success because of the strong link to the international division of labour, but it is also a problem because the less developed parts of the Chinese economy are excluded, and the national economy is threatened with a process of regional disintegration.

Thirdly, the character of FDI has changed. Since the early nineties 'export processing' by foreign-invested firms has become less important. Production by foreign-invested firms is still in many cases export oriented, but the number of such firms producing for the internal Chinese market has increased. This is one major reason for the poor performance of SOEs, as joint ventures and wholly foreign-owned firms reduced the monopolistic protection of incumbent firms, especially SOEs, and are much tougher competitors than the collectively owned enterprises, which in most cases are of small or medium size.

Fourthly, FDI inflows have aggravated regional disparities due to the concentration of FDI in the coastal provinces.[24] The negative impact of this could be attenuated if regional spillover effects promote the hinterland, but FDI has raised the danger that an economic dualism between a modern and a traditional sector could become entrenched.

The growth in exports of goods and non-factor services is impressive (Table 1). Thus it seems that China's growth rates have been strongly driven by exports. However, the growth of exports and imports was more or less balanced. While there is no doubt that export performance has contributed to the country's growth, because of the structure of exports and the role of 'export processing', exports have contributed less to growth than is suggested by the macroeconomic figures. A more relevant factor than the export performance would seem to be that China prevented the emergence of substantial, long-term

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[21] See, for example, N. R. Lardy, op. cit, p. 9.

[22] Fan Zhi-Jian: Ausländische Direktinvestitionen in der VR China. Rechtliche und finanzwirtschaftliche Rahmenbedingungen, Dissertation, Gießen 1993.

[23] Delegation of German Industry and Commerce: Informationsbroschüre, Shanghai/Beijing 1997.

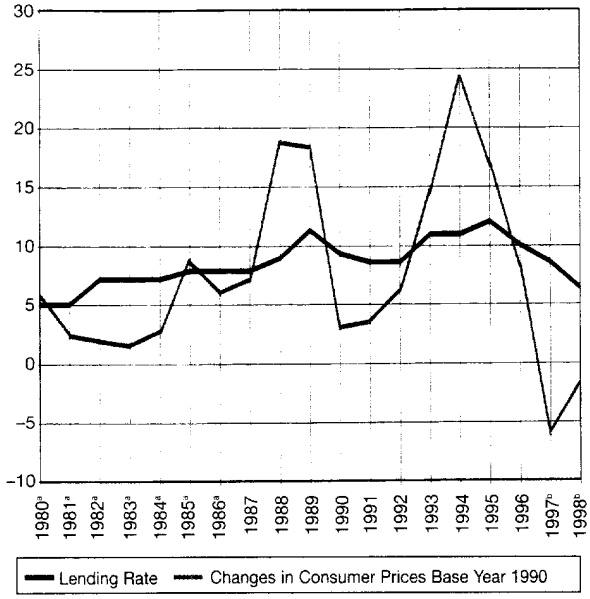
[24] W. Urban: China's FDI Policy Reconsidered, in: The Vienna Institute Monthly Report, No. 1, 1996, pp. 32-40.

current-account deficits, and avoided currency crises. Both are related to the restricted convertibility of the Chinese currency, and to the existence of tariff and non-tariff trade barriers which are still high. In comparison to CIS-countries it is very hard to export consumer goods to China. This has forced Western enterprises to invest in China rather than just exporting their products.

Financing Investment

Investment has to be financed. In China there still exists a credit plan that was inherited from the planned economy and which has been relaxed only gradually. The credit plan restricts the quantity of the loans given by the banking system and also sets lending and deposit interest rates.[25] Given the huge investment hunger of SOEs, and the fact that other enterprises' credit demand is also very high, the demand for credit always exceeds the supply. The financial system in China is consequently characterised by credit rationing, and some potential borrowers cannot satisfy their demand for credit at the going interest rate. In addition the demand for credit was boosted by low nominal interest rates. In some periods, such as 1988-89 and 1993-1995, lending rates were substantially lower than inflation rates (cf. Figure 4). In this way, low and sometimes negative real interest rates stimulated investment[26] and thus the demand for credit by all types of enterprises.

Figure 4
Nominal Interest Rates on Loans



[a] Overall Retail Price: The World Bank: The Chinese Economy, Fighting Inflation, Deepening Reforms, Washington D.C. 1996.
[b] The People's Bank of China: Quarterly Statistical Bulletin 1999-1.

Source: IMF: International Financial Statistics 1997.

SOEs were privileged by the banking system, dominated as it is by the four old state-owned banks. By contrast, collectively owned enterprises and private enterprises have had only limited access to state banks. Their rapid accumulation has had to be financed by other funds.

For the financial system credit rationing has had two effects:

☐ Firstly, there is an informal credit market of considerable depth. The loans extended in informal rural-credit markets surpassed those in formal rural-credit markets in 1986. All told, it is estimated that informal credits amount to as much as half the value of formal bank lending.[27]

☐ Secondly, non-bank financial institutions, for example (International) Trust and Investment Corporations, (I)TICs, mushroomed with the aim of circumventing official credit markets. Even the state-owned banks founded such institutions to circumvent government regulations. Non-bank financial institutions created many problems for monetary policy since, in some periods, credits expanded much faster than planned. This was especially the case during the inflationary periods of 1988-89 and 1993-94, and during both periods the monetary authorities took bold steps to control non-bank financial institutions. In 1993 the universal banking system was abolished to make it easier to control the banking system. Commercial banks had to close or sell their (I)TICs and were no longer allowed to hold shares.[28]

The banking system in China is in a bad shape. Budget deficits are relatively low but the banking system has had to take over quasi-fiscal deficits. In particular, the banks have had to finance loss-making SOEs which, in general, not only have a poorer productivity performance than other types of enterprises, but also have to finance the social safety net. In this way, a substantial part of bank credits to SOEs have functioned as a substitute for government subsidies.

[25] The credit plan used to cover all credits given by the financial system. It now covers the four state-owned banks that dominate the Chinese banking system.

[26] World Bank: The Chinese Economy..., op. cit., p. 29.

[27] B. Naughton: China's Financial Reform: Achievements and Challenges, BRIE Working Paper 112, 1998.

[28] Z. Feng, T. Cao: Über einige Probleme des chinesischen Banksystems, in H. Herr, K. Hübner (eds.): Der lange Marsch in die Marktwirtschaft, Berlin 1999.

Table 3
Subsidies to State-owned Enterprises
(in per cent of GDP)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Through the budget[1]	7.5	7.5	7.2	6.4	6.9	6.4	5.2	3.9	3.1	2.2
Through the banks	2.4	2.4	3.0	0.6	–0.1	–0.2	0.6	3.6	3.2	1.7
Total	9.9	9.9	10.2	7.0	6.9	6.2	5.8	7.5	6.3	3.9

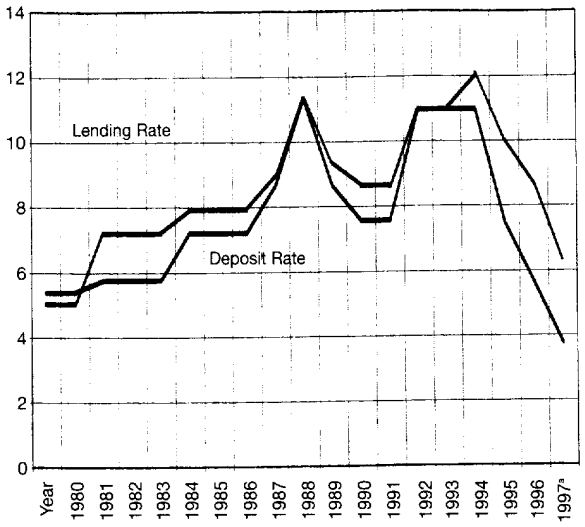
[1] Including price subsidies.

Source: World Bank: The Chinese Economy. Fighting Inflation, Deepening Reforms, Washington, D.C. 1996.

Table 3 shows substantial quasi-fiscal deficits, as estimated by the World Bank. Estimates of quasi-fiscal deficits in more recent years are difficult to obtain, but it seems that direct subsidies by the state have been further reduced. Thus, as the losses of SOEs have increased since 1995, it seems that quasi-fiscal deficits have increased as well.

The banking system has also faced additional burdens. Banks' interest rate spreads are narrow even at the best of times (Figure 5). During some periods, deposit rates for a particular maturity have been higher than lending rates. During inflationary periods in particular the government has been unwilling to impose the full cost of restrictive monetary policy on enterprises. It has therefore used credit rationing rather than interest rates to reduce the inflation rate. At the same time it has had to increase deposit rates to prevent the withdrawal of deposits by households and (illegal) capital flight. In particular, long-term savings deposits by households were implicitly indexed to keep real interest rates positive for households. At its most extreme, the spread between long-term deposit and credit rates has been negative by as much as 15 percentage points. Finally, banks have frequently written assets off, as local governments often forced banks to bail out enterprises during periods of restructuring.[29] Under such conditions it is not surprising that the banking system has to carry a large amount of bad debts and has a negative net value (see below).

Figure 5
Lending and Deposit Rates



[a] The People's Bank of China: Quarterly Statistical Bulletin 1999-1.

Source: IMF: International Financial Statistics 1997.

Structure and Deficiencies of State-owned Enterprises

State-owned enterprises, as pointed out, have grown gradually out of the plan following the 'dual track' approach to transition. The Chinese government refrained from privatisation, and instead supported competition from collective enterprises, newly created private firms and foreign-funded firms. The commands of the central plan faded and were increasingly substituted by the growing autonomy of SOE management, almost complete price liberalisation (although price controls remained in some branches, such as coal and other forms of energy), and tax contributions instead of physical production targets. However, the degree of centralisation had always been lower than in planned economies of the Soviet type, due to the fact that the provinces have enjoyed a limited measure of autonomy. The main accomplishments so far have been as follows:[30]

☐ The share of production accounted for by SOEs has declined while that of collectively owned and private firms has increased – until 1998 without a slowdown in macroeconomic growth.

[29] B. Naughton: China's Financial Reform: Achievements and Challenges, op. cit., p. 9.

☐ The productivity and output of SOEs has increased, although at a much slower rate than is the case in competing enterprises, and the competitiveness of some, but not all, SOEs has improved; however, very little information is available about the degree of monopoly and other competitive restrictions in goods markets.

☐ The tax system has changed and now relies mainly on value-added taxes and only to a small extent on the company taxes which prevailed previously.

Nevertheless, the move away from a planned economy has only been partly successful. Some SOEs have managed to become competitive, profitable firms that are ready for privatisation, but many have only taken a few steps along what is a long road, and the majority of enterprises are probably somewhere between these extremes. The main negative features which affect the bulk of SOEs are as follows (see Box 1):

☐ Soft-budget constraints are widely prevalent due to the financial sector (soft loans, high degree of working-capital credit, low interest rates), the government (subsidies, although these are decreasing), restricted competition in goods markets and barriers to exit options due to weak bankruptcy legislation (and practice).

☐ State welfare functions, such as housing, health and unemployment insurance, schooling, and pension schemes, are still fulfilled by SOEs. Since labour is still tied to enterprises in a 'danwei' fashion, employment is not very flexible, with the result that there is extensive over-manning and hidden unemployment.[31] As the proportion of contracted workers increases, and protection against dismissals declines, capitalist labour markets are slowly intruding on SOEs. Wages are often raised through bonus payments without much relation to productivity, thereby lowering the level of profits or inducing inflationary pressure.

☐ The level of restructuring is low, capital and technology inflows have been too small, and enterprises have been preoccupied with expanding their capacity. Changing socialist production units into fully-fledged independent capitalist firms, with management and marketing functions as well as financial responsibility, and with the sole aim of earning profits for the proprietors is still a long way off for many SOEs. Furthermore, many SOEs suffer from being too small to take advantage of economies of scale. A key indicator of the insufficient competitiveness of SOEs is the low level of exports, which contrasts sharply with the high level of fixed investments.

☐ There is a vacuum of corporate governance with a variety of principal-agent conflicts.[32] On the one hand, the state does not fulfil its function as a principal, and the management, due to asymmetric information, can use its newly gained autonomy for individual or other non-capitalist purposes, such as private rent-seeking, asset-stripping, employment conservation, survival of the regular workforce etc. On the other hand, the state intervenes in the SOEs, maintaining soft budget constraints and low competition so as to avoid labour shedding. As a result, management's autonomy is too restricted to pursue a thorough restructuring.

☐ The ultimate result of the above mentioned deficiencies is the weak financial performance of many SOEs: they have too little equity capital, since the only source of capital is bank loans; due to the soft budget constraints, losses have accumulated and enterprises have built up a high stock of bad debts which are partly non-performing.[33] In addition to current losses, the heritage of the old planning system led to a lack of equity capital. In a planned economy, enterprises and banks do not need either profits or the amount of equity capital required by normal capitalist firms. As a result, many companies are now characterised by a strong under-capitalisation by comparison with the standards of a market economy, and this can threaten their survival even if their performance prospects indicate that they are viable. Since the over-indebtedness of SOEs will, under a regime of soft budget constraints, not necessarily lead to bankruptcy, state banks are urged to continue lending, thereby becoming considerably over-indebted themselves. In this way, banks and SOEs, as well as the responsible government institutions, develop a common self-interest in the prolongation and accumulation of debts. Debt accumulation has therefore become a time bomb. SOEs might turn out to be

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[30] See M. Raiser: Die Rolle der Staatsunternehmen in der Systemtransformation: Die Erfahrungen in der VR China, in: Die Weltwirtschaft, Vol. 3 (1995), pp. 340-361; H. Feldmann, S. Opper: Die neuen Reformen der chinesischen Staatsbetriebe, in: Osteuropa-Wirtschaft, Vol. 43 (1998), No. 4, pp. 396-414; W. Zengxian: How Successful Has State-owned Enterprise Reform Been in China?, in: Europe-Asia Studies, Vol. 49 (1997), No. 7, pp. 1237-1262; D. Parker, W. Pan: Reform of the State-owned Enterprises in China, in: Communist Economies & Economic Transformation, Vol. 8 (1996), No. 1, pp. 109-127.

[31] S. Opper: Chinesische Beschäftigungspolitik zwischen Stabilitäts- und Effizienzzielen, in: ASIEN, Vol. 65 (1997), October, pp. 23-38.

[32] Y. Qian: Enterprise reform in China: agency problems and political control, in: Economics of Transition, Vol. 4 (1996), No. 2, pp. 427-447.

[33] World Bank: The Chinese Economy..., op. cit.; World Bank: China's Management of Enterprise Assets: The State as Shareholder, Washington, D.C. 1997.

bottomless pits leading to a financial crash or into debt-reducing inflation. The bad-debts problem is the price of adopting the path of gradual transition, and of avoiding the exit of non-viable, unprofitable enterprises.

Until the end of 1996 only 5,800 SOEs had been transformed into corporations. Corporatisation is a key step in the process of separating enterprises from the state, and managers have been hesitant to cross this threshold due to their fear of being subjected to the control exercised by the market and greater competition. In practice, it has mainly been the well-performing SOEs that have opted for corporatisation. On the other hand, there has been a huge wave of de facto privatisations – mainly to insiders – of small enterprises which could no longer obtain financial support from local authorities. The sale of these assets was eased by a low price – buyers had to assume enterprises' old debts – and the high stock of household savings. Another form of covert, partial privatisation has been the sale of minority shareholdings through the domestic stock markets, something that has already affected more than 600 SOEs.

Will SOEs Cause a Transition Crisis?

The core problem with the attempt at a gradual transition of SOEs is threefold, and not specific to China: (1) A transition from plan to market involving extensive structural and technological change requires the devaluation and scrapping of fixed capital which cannot be restructured and employed profitably. If exits are deferred, problems will accumulate, resulting eventually in a wave of shutdowns. A gradual approach offers the chance to use the time for change and restructuring; to the extent that this approach does not succeed, losses and debts will go on rising. (2) If the devaluation of capital is repeatedly deferred, the eventual impact of firm closures on employment will be greater and more abrupt. (3) The bad-debts problem of SOEs can multiply and affect the stability of the financial sector. If the old debtors prove incapable of paying their debts somebody else must pay instead. If credit chains break down, so that banks and other enterprises become illiquid, and the central bank refuses to act as lender of last resort, a late but severe transition crisis will emerge.

In the case of China a fourth problem must be added: since the contribution of SOEs to capital accumulation has been so astonishingly high, the collapse of their investment would lead to a decline in the investment ratio, and the demand for investment goods would shrink. Capacity utilisation in the investment goods industries – state as well as private – would then decline. This decline in the rate of growth of demand for investment goods would be permanent if it were not compensated for by newly induced private investment demand. As is well-known, household savings in China are high, but there is no reason to believe that this will induce an equivalent quantity of investment by firms; it could, rather, impair consumption. As a consequence, growth rates would be impaired. Furthermore, declining growth rates would probably not be accompanied by reduced rates of productivity growth, so that productivity increases, especially those resulting from labour dismissals, would cause a severe surge in unemployment.

The function of a transition crisis would be to destroy old, unprofitable capital; to make up for the deferred shedding of labour; to compensate or even expropriate creditors; and to kick unprofitable SOEs and even loss-making banks out of the markets. The outcome should be the survival of those companies and banks that are profitable and sufficiently capitalised, and the closure of the rest.[34] But as with every macroeconomic crisis, a transition crisis would lead to a process of overshooting which could undermine the performance of otherwise profitable firms and jeopardise their survival, especially if banks go bankrupt. In the course of a transition crisis, there is a danger that growth will be depressed as a result of a path-dependent development with hysteresis and self-reinforcing negative long-term expectations.

How likely is this worst-case scenario? There is no guarantee that a postponed transition crisis will not ultimately occur. There are three factors that might trigger such a crisis, leaving aside exogenous shocks associated with the aftermath of the Asian crisis:

☐ The size of current losses and the true stock of bad debts might turn out to be much larger than the present statistics suggest. The proportion of non-performing credits depends not only on definitions (e.g. including inter-enterprise arrears) but also on the continuing flow of fresh money from the banks, on interest rates and on macroeconomic growth. During deflation real interest rates rise. Over-indebted banks have strong incentives to extend even more credits to bad debtors. In addition, losses can be hidden by a low degree of competition which leads to quasi-monopolistic pricing. The good profit performance

[34] In most transition countries the emergence of a profitable enterprise sector starts before the financial sector turns to profitability. Hard budget restrictions normally first apply to the companies whereas banks are submitted to more gradually hardening restrictions. The main reason is that the exodus of financial institutions has a larger macroeconomic impact and may conflict with the function of the central bank as lender of last resort.

reported for the majority of large SOEs in official statistics might to some extent be caused by such factors. On the other hand, the decreasing losses of SOEs – from a peak of 10.5 per cent of GDP in 1992 to 7.0 per cent in 1995 – indicate improvements.[35]

☐ If the restructuring of SOEs is further delayed, if budget constraints remain soft or become even softer, and if debts grow even faster, then the long-term perils of debt accumulation, including the probability of a debt crisis, will grow. Here it is important to distinguish between soft-budget constraints with respect to outstanding credit stocks and to current credit flows. Hardening the financial discipline of SOEs (and banks) must primarily relate to the flow problem. To impose a hard budget discipline on credit stocks will in many cases be impossible if disastrous crashes of viable firms are to be avoided.

☐ If a sudden U-turn in monetary, fiscal and industrial policy led to a hard budget constraint on SOEs, as practised in well-developed market economies, there is no doubt that this would result in mass bankruptcies, an upsurge of unemployment, a reduction in investment and major repercussions for the financial system. If the four state commercial banks were suddenly faced with a hard budget constraint in relation to both their stock of old debt and the flow of fresh credits, the solvency of the banking system would probably be jeopardised. In particular, if the central bank were to adopt a restrictive monetary policy through high interest rates, the burden of bad debt would increase. A major policy shock could also occur if goods markets were suddenly exposed to strong competition, induced perhaps by an ill-prepared entry to the WTO. Another type of policy shock could occur if a mass privatisation programme led to the widespread closure of unprofitable firms for which no private investors could be found.

However, a more optimistic scenario seems likely. If the time 'created' by the gradual approach is used resolutely to promote restructuring, the destruction and devaluation of capital and credits can be stretched out over a longer period. The introduction of hard budget constraints must be implemented as part of a step-by-step strategy: while the stock of bad debts must be transferred from SOEs to the banks or the government (or both), new credits should be subject to harder controls. If non-performing loans amount to approximately 20 per cent of GDP, as indicated by official figures, the problem would not seem to be greater than in many other transition and less-developed countries;[36] even the Japanese debt crisis, although caused by very different factors, appears to be of comparable dimensions. If the old debts were transferred completely to the state budget, with interest rates of 5 to 10 per cent, the interest payments would amount to between one and two per cent of GDP. Tax increases for this purpose might pose political difficulties, but they would not constitute a serious economic problem. Given that state expenditure is very low relative to GDP, debt redemption does seem feasible. It might be objected that SOEs and state commercial banks are both in urgent need of equity, and that they need to be capitalised as well as provided with debt relief. However, when SOEs and banks become profitable they can use their profits to provide equity. Further-

[35] World Bank: The Chinese Economy..., op. cit., p. 11.

[36] For comparison, the share of bad debts relative to the stock of total bank credits in 1997 reached 29 per cent in the Czech Republic, 33 per cent in the Slovak Republic, 49 per cent in Albania and 57 per cent in Romania (see EBRD 1998). In 1998 the figure for Russia is estimated over 40 per cent (iwd 1999).

more, private households or non-bank institutions find it attractive to invest their capital in SOEs and banks – provided that privatisation is permitted, at least partially. And provided that growth is sustained at a rate that is higher than the rate of interest, there is no problem with a budget deficit that is high in relation to GDP, so that a deficit emanating from SOE and bank deficits would not undermine a sustainable fiscal policy.

Nevertheless, current SOE losses should be diminished. A stronger approach towards restructuring and closures is required in relation to hopeless, loss-making enterprises. With the gradual hardening of the budget constraints facing banks and SOEs, unemployment will rise and the inclination to invest will be hampered unless private firms expand their investments. This is where the key problem facing the optimistic scenario arises: will the high fixed investment, driven mainly by pre-capitalist logic during the last twenty years, persist if the Chinese economy makes a big step towards a market economy? The problem of bad debts seems soluble, but the likely impact of hard budget constraints on investment could well dampen future growth rates. It seems clear that for firms exposed to tough financial discipline, strict calculations of profitability will shift investments onto a considerably lower path.

Even a slight reduction in growth will trigger substantial negative employment effects and the attendant political consequences. Since the Chinese labour force increases by some 15 million people a year, and productivity growth is high (despite being repressed by extensive regulations), a growth rate of 7 or 8 per cent is regarded as an important political goal. With the destruction of the old social safety nets provided by SOEs, dismissed workers fall into the gap between the old system and the new welfare net that has yet to be established. This seems to be another weak point in the Chinese transition strategy that is causing sharp political tensions.

Maintaining High Growth with Fiscal Policy?

In 1998 the Chinese economy began to experience a slowdown in economic growth although, following the adoption of a massive programme of fiscal expansion, growth might only fall to 7.8 per cent. But it has so far not proved possible to prevent a noticeable deflation. It is, however, not the traditional type of deflation, characterised by a decline in the level of output, since it is only the rate of growth that is falling. What are the causes of the reduced growth rate and how do they relate to the problems of transition in China?

There are four factors impeding growth and depressing the level of prices:

☐ Exports have suffered a marked decline after years of rapid growth. A combination of the Asian crisis and the Chinese policy of keeping the exchange rate unchanged has led to a decline in demand from Asian countries and a real effective appreciation of the renminbi. As some Asian currencies depreciated by as much as 80 per cent, the appreciation shock had an enormous impact on China. Import prices fell, thereby inducing downward price competition, amongst other factors due to a major reduction of tariffs. Deflation, therefore, appears to have acted as a kind of substitute for devaluation. The export losses could not be compensated for by increased exports to the USA and Europe. However, since imports also declined – due to lower domestic demand – the deterioration of the trade balance was kept within limits. The effect of the reduced exports was, rather, to curb domestic consumption and investments.

☐ Investment has been reduced as a result of the imposition of harder budget restrictions on SOEs and banks, higher real interest rates and increasing overcapacity following the previous investment boom, which involved both SOEs and their competitors in the private sector. These factors have all contributed to diminished profit margins. In addition, investors' expectations have been depressed as a result of the contagious effect of the Asian crisis and the Japanese recession, and the impending prospect of a devaluation of the renminbi. Growing uncertainty has triggered a wait-and-see attitude towards investment on the part of many firms. However, inflows of foreign direct investments have not yet been affected, partly because government incentives have been increased.

☐ Nominal wages, and especially profit-related bonus payments, have come under downward pressure as a consequence of rising urban unemployment and the sluggish demand for goods, thereby reinforcing deflation. Deflation normally tends to raise real wages due to more or less rigid money wages, or, to put it in other words, rigid nominal wages due to strong trade unions are usually an effective barrier against deflation. However, as a result of weak trade unions, and a high incidence of profit-related pay, nominal wages in China are (too) flexible.

☐ Private consumption growth has been reduced as a result of the high personal-savings ratio. This has been encouraged by the uncertainties associated with job insecurity (and the lack of functioning unemployment insurance) and by a distribution of income which

increasingly favours higher-income groups with a lower propensity to consume. Consumption has also been affected by the slower growth of employment.

To counteract the impending deflationary slowdown, the Chinese government has opted for a traditional Keynesian policy of fiscal expansion. Monetary policy has accommodated the fiscal strategy but is itself subject to tight constraints: interest rates that are too low, or the allocation of large volumes of credit to the commercial banks, could undermine the efforts to impose harder budget discipline on banks and SOEs. In fact, due to deflation, real interest rates are quite high. Given that private and state-owned firms are hesitant to invest because of the prevailing overcapacity, that export promotion within the depressed Asian environment is futile, and that devaluation might trigger a new wave of destabilisation in Asia, a strong fiscal stimulus is undoubtedly the correct approach. The adoption of such drastic measures has, perhaps, also been motivated by the – well-founded – fear of following in Japan's footsteps. It should also be noted that there is no sign of any inflationary pressure in China, that the budget deficit is low (1.6 per cent of GDP in 1997),[37] that there is a tremendous lack of infrastructure (something frequently pointed out by the World Bank) and that any withdrawal of capital from the country is hindered by capital controls.

Additional expenditures for which credit has been allocated by the commercial banks amounted to some 200 billion yuan or 2.5 per cent of GDP in 1998.[38] These infrastructure programmes are to be continued in 1999 and 2000. The programme of investment promotion is also intended to support private and SOE investments. The 9th Five Year Plan, which covers the years 1996-2000, has been modified, so that gross fixed investment is now supposed to grow by 15 per cent per annum from 1998 to 2000. Other measures include the emission of treasury bonds worth US$ 35 billion in order to recapitalise the four state banks; a proposed halving of employment in the civil services; and a cut of half a million in the number of military personnel (equal to 16.5 per cent). These measures are intended to maintain 8 per cent growth in 1999 and subsequent years.

Will fiscal policy accomplish its ambitious goals? Without question, the expansive impact on demand will have an effect in the short term, counteracting deflation without creating inflationary pressure. But whether future growth can be sustained depends largely on the behaviour of consumers and investors, which is unpredictable. If improved short-term expectations also serve to promote brighter medium and long-term expectations, then a short-term fiscal impulse, over just a few years, could generate a sustained effect. In addition to reducing uncertainty, fiscal policy also entails supply-side improvements: infrastructural bottlenecks will be reduced and the production potential enlarged. In this way, fiscal policy could successfully bridge a difficult transition gap created by domestic restructuring (principally the changing investment patterns of SOEs) and by exogenous shocks arising from the Asian crisis. Despite the limited demand impulses of fiscal policy, its long-term effect would be to keep growth more or less high, along a path that is not quite as steep as it has been, but that is nevertheless sufficient to maintain labour-market stability. If firms and households expect this future growth path to be achieved, this would be a perfectly rational expectation, and not a matter of deception or short-term irrationality.[39] But, of course, there is no certainty that the outcome of policy measures will be that positive – the transition to a market economy makes macroeconomic performance highly dependent on decentralised private expectations.

One qualification must be added to this rather optimistic judgement: the expansive fiscal policy might be regarded as a substitute for hardening the budget constraints (concerning credit flows) facing SOEs and state banks, as is claimed by some commentators who point to a change in political priorities. If this were the case, there would be an economic relapse. The expansive investment behaviour of SOEs and state banks would resume, and the problem of bad debts would be exacerbated. At all events, there is no alternative to steering a path between the sudden imposition of hard budgets, which would inevitably lead to a financial crash, and a slack path which avoids change, which would lead to even more severe debt redemption problems in the future.

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[37] The stock of public debts amounted to 30 per cent of GDP in 1998 (World Bank: The Chinese Economy..., op. cit.) If the SOEs' current deficit (7.0 per cent) is added to the budget deficit, the aggregate public sector deficit amounted to 8.7 per cent of GDP in 1995 (ibid., p. 11). However, this indicator is misleading since enterprise deficits must be balanced with their investments.

[38] See B. Reddies, op. cit.; Länderanalysen der Frankfurter Allgemeinen Zeitung und des Ostasiatischen Vereins e.V., 'VR China/ Hongkong', Frankfurt am Main, November 1998.

[39] Economic units do not neutralise the credit financed fiscal stimulus by rational expectations of future tax increases and increased saving. In the case of a demand deficiency which the government combats by means of fiscal policy, households and firms know that they will all achieve a higher growth path providing higher incomes (see J. Tobin: Asset Accumulation and Economic Activity, Oxford 1980, p. 91 ff.)